

Economic Report

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Commentary
on Pertinent
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Issues

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Restructurings, Takeovers and Debt

Streamline. Restructure. Become lean and mean. Reorganize. Spin off. Buy back. Merge or acquire. These and other words are being used to describe what amounts to the greatest overhauling of corporate America in the postwar era. Many of today's top companies look very different than they did just a few short years ago. Some corporations have gotten bigger by buying others, while other companies have become smaller by selling some of their divisions. By some estimates, nearly a fifth of the current market value of all traded stocks has changed hands in the past four years alone.

Wall Street has apparently voted in favor of this corporate reshuffle. In the first nine trading days of this month alone, stock prices surged by more than seven percent, sending the averages into record territory. Of course, there are others, especially those who have had to restructure their companies because of takeover threats, who decry these developments. Their words have not fallen on deaf ears in Washington, since a number of congressmen have begun to talk about the need for legislation to suppress, or, at the very least, regulate such activity.

Neither side has a clear-cut case. Like so many other things that happen in our economy, these changes are either good or bad depending upon one's perspective. What follows below is an attempt to lay out both sides of the arguments that have been made on the subject of restructurings, takeovers and debt.

PRO

The separation of ownership and control in most publically-held companies has resulted in managements pursuing size for its own sake to justify higher pay, more perquisites and greater social status for themselves. Those who have sought to take over companies, whether successful or not, have forced management to think more like owners and to boost shareholders' values.

CON

In many instances this has resulted in companies taking a short-run view at the expense of the longer term. Assets have been reshuffled; companies have gone private, then public; owners have changed frequently without any basic change in operations. In any event, many companies have already been forced to become leaner by competition both here and abroad.

Big business may be characterized as bloated, risk-averse, inefficient and unimaginative with excessive layers of staff between managers and markets that has been dubbed "corpocracy". Large corporate size is believed to correlate more with high executive pay than with high profits or stock prices.

Large size by itself should not be condemned since it has many redeeming qualities including stability and predictability, not to mention economies of scale. At any rate, companies of all sizes would do better if U.S. economic policies were more appropriate. Washington's record budget deficits adversely affected companies both large and small by pushing interest rates to record levels several years ago, thereby making the dollar so strong as to destroy our competitiveness both here and abroad. Tax reform will only worsen matters by depriving many businesses of the incentive to invest, thus keeping them from becoming more efficient.

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If raiders are opportunists, poor management has given them the opportunity. These raiders must see value in what they are buying; they obviously believe they can do better than current managements, otherwise they would not offer a premium over listed market prices. In some respects they are buying up companies at wholesale prices and selling off parts at retail prices. At any rate, leaner, more efficient companies are resulting, not only from actual takeovers, but from fears of them as well.

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Defenses that companies are erecting to maintain their independence wind up costing jobs as divisions are spun off and staffs whittled down. Funds that would otherwise be invested in research and development are instead paid out to shareholders, sacrificing long-run growth potential, productivity and competitiveness. Naturally, this hurts the economy. Insofar as raiders doing better than management is concerned, we don't know, since few have actually wound up owning the companies they threatened to take over. What is more, if the stock market did not undervalue Corporate America, these raiders would not be able to buy at wholesale and sell off parts at retail. Managers are so busy worrying about takeovers that they have difficulty concentrating on competitiveness.

Let's follow up on the undervaluation of Corporate America by the stock market. It has been calculated that the Q ratio, or the market value of corporate assets as a proportion of their replacement costs, although up in line with the jump in stock prices, is still below one. Therefore, it pays to buy stocks in order to obtain corporate assets rather than to build new assets directly. Correcting for inflation, the popular market averages remain anywhere from 25 to 45 percent below the peaks they reached in the 1960s, while real nonfinancial corporate assets have more than doubled in value over this time.

Reorganization doesn't always create value. The company must be able to increase its sales volume or selling prices or become more efficient in order to justify higher share prices. Otherwise, this is a zero-sum game: Someone gains because someone else loses.

The stock market likes these restructurings, since it places greater value on companies engaged in this pursuit on the notion that restructurings will produce more efficiency and more profits.

The stock market may overestimate a company's breakup value. It may also overlook debt taken on which will not be used to finance the purchase of plant and equipment or for research and development, thus enabling the company to grow and better service this debt. Besides, the rating agencies have lowered their opinions of companies taking on these large debts, while recent studies have suggested that merger and acquisition situations eventually result in lower stock prices for the company or companies involved, rather than higher.

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Let's talk about debt. More leverage enhances shareholders' returns. The tax law—even under tax reform—still makes debt less expensive than equity, since interest costs are deductible while dividends are not. What's more, high debt levels put managers under pressure, thereby encouraging them to improve their performance.

Debt levels aside, if you make managers into owners, they will do a better job. Managers should have more than a nominal amount of equity in the companies for which they work. At the very least—they should think more like owners.

The purpose of business is to make money for its owners—which many of today's managers seem to overlook except when they are pushed.

Focused firms do better.

Actually, some corporations make life insecure by going into areas that they don't know, many times with negative results. These corporate errors tend to be tolerated, but raiders cannot afford such mistakes.

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High interest costs associated with greater debt levels will hurt when the next recession comes around and corporate profitability, thus cash flow, is diminished. Interest paid as a percentage of pretax profits, although down from its 1982 peak, is still around 50 percent, compared with less than 25 percent in the 1970s, and around 10 percent in the 1950s and 1960s. Higher debt levels means funds must be diverted from such other uses as research and development, job creation and capital spending to pay interest. In any event, managers should not have to operate at gunpoint; worthwhile corporate goals can be achieved through economic growth and technological change.

It may be true that managers should never lose sight of the fact that they are managing their companies on behalf of the owners. However, it is also true that owners nowadays tend to be big institutions themselves, such as pension funds, life insurance companies, bank trust departments, etc., whose holdings are diverse and whose attachment to the companies whose stocks they own lasts only as long as quarterly earnings are strong. In addition, most firms have to cope with a broad range of special interest groups besides those of their owners. Businessmen must deal with governments at various levels, unions, local community groups, and the press. Because of these diverse audiences, it is not practical for managers to run their companies with the immediacy demanded by the raiders.

What about the responsibility that a company has to its employees, to the community in which it is domiciled, and to society at large? These obligations can only be measured by taking a longer-term view.

Diversification is an anti-cyclical measure. When one industry is down another might be up. This helps to keep the company strong and its jobs secure.

No company deliberately goes into an area that it doesn't know. Companies diversify in order to smooth out the impact of the business cycle as well as to grow. Flexibility is important.

(Continued)

As you can see, there are good arguments on both sides of the restructuring phenomenon that has stuck Corporate America these past few years. No doubt some of these overhauls have been necessary. There may be some truth to the argument that when ownership is separated from control, managers tend to act in their own self interest, rather than those of the shareholders. However, some of the tactics that have been employed to rid Corporate America of these alleged excesses and inefficiencies are questionable at the very least.

In particular, there is the development that has come to be known as "greenmail". This is the ransoming by a company of its stock from the clutches of a raider who has bought some shares and has threatened to buy enough to take it over. This practice should be eliminated by making it illegal for a company to buy out one shareholder at a price not offered to all the others. This would also help to curb another abuse: The threat of a takeover without binding finances which stampedes stock into the hands of arbitrageurs and speculators by putting a company into "play". Many corporate managers believe that raiders don't really want to run companies—they just want to make a quick profit. If greenmail were eliminated, the raiders would have to make good on their threat to take over the firm.

It is too soon to say with certainty what the impact of these restructurings has been on the economy, since the process has not played itself out. So far, there have been winners and losers. The winners, of course, are those who have invested in the stock market, where prices have risen reflecting in part, the reduced supply of equities in the public arena and the realization that stock prices have undervalued the assets of Corporate America.

Among the losers are holders of corporate debt instruments when restructuring produces additional issuance of debt, as well as employees who have lost their jobs through corporate downsizing. While these restructurings are supposed to improve efficiency, growth in output per hour worked in the private business sector has been much slower in this expansion than it has in the past; productivity actually flattened during most of 1986.

Finally, the ability of Corporate America to handle higher and more expensive debt loads will not be fully tested until the next recession rolls around. Given the shape of their balance sheets, many corporate managers are not looking forward to taking this particular test.



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